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April 17, 2009

AGENDA ITEM 7

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Policy Review and Consolidation Project – Revision to Real Estate Policies (Third Reading)
- II. PROGRAM:** Real Estate
- III. RECOMMENDATION:** Recommend to the Investment Committee adoption of the Statement of Investment Policy for Real Estate in June 2009
- IV. ANALYSIS:**

Background

A comprehensive policy review was indicated as part of the Real Estate Strategic Plan adopted by the Investment Committee in September 2007.

In December 2008 Staff presented a second reading of the overarching policy draft. In the second reading, the major change requested by the Policy Subcommittee was to clarify that the Board's Real Estate Consultant ("Real Estate Consultant") reports directly to the Investment Committee. That change has been made (Section III.B).

Subsequent to the December reading, the CalPERS Legal Office ("LEGO") and Investment Staff requested an external legal review of the policy draft. Pillsbury Winthrop Shaw Pittman LLP ("Pillsbury") has advised CalPERS on a number of legal issues in the real estate portfolio recently and it was determined their input would be useful. Pillsbury was selected to perform the policy draft review.

Major Changes as a result of Additional Legal Review

Investment Staff, LEGO, Pillsbury, and Pension Consulting Alliance, Inc. ("PCA"), the Real Estate Consultant, held several meetings to discuss Pillsbury's

comments and suggested changes. Staff recommends changes to the policy draft as highlighted in blackline format in Attachment 1. Tracked changes in Attachment 1 are from the second reading policy draft presented to the Policy Subcommittee in December.

Many changes suggested by Pillsbury are for language clarification purposes. Material changes are suggested in the areas of investment structures and leverage. The following is a summary of the major changes with references to the applicable policy section:

1. Hazardous Waste (Section V.H.7)

An outstanding item on the policy project was for Real Estate Staff and LEGO to complete an analysis of Hazardous Waste risks and to determine placement of mitigations in policy or procedures. Language addressing Hazardous Waste risks was changed. It is the recommendation of LEGO and Real Estate Staff that mitigation measures for Hazardous Waste risk should be outlined in the Staff Internal Procedure Manual similar to the other real estate risks.

2. Investment Structures (Section VII)

Extensive changes were made to the language of this section primarily with the purpose of clarifying the underlying intent. Separate Accounts (term changed from Joint Venture) will be required to comply with current real estate policies. First and second reading drafts required compliance with real estate policies in place at time of execution of the partnership. A Downstream Joint Venture investment structure was added (Section VII.A.5) to address issues with respect to this type of structure (joint ventures between investment partners and third-parties).

3. Leverage (Section X)

Several changes were made to the Leverage section:

Leverage Limitations. Public Real Estate Securities, which are allowed to comprise up to 25% of the total real estate portfolio, were excluded from the leverage limitations. The concern is the difficulty in measuring the Loan-to-Value ("LTV") data for numerous small public securities holdings. Typically the LTV of real estate public securities globally has averaged from 30% to 50%, although given the current capital crisis, the average US public real estate securities' LTV is approximately 60%, with ex-US LTV lower.

Leverage Structures. This section was reorganized to emphasize the distinction between recourse and non-recourse debt. As with prior drafts, CalPERS will have two categories of recourse debt; Subscription Financing

and Credit Accommodations. The limitations on recourse debt were made more conservative on the following points:

- A. The overall recourse debt limitation remains the same on a percentage basis at 10%, however, the earlier limitation was just 10% of current Net Asset Value. The new limitation is now based on the lower of current Net Asset Value or target Net Asset Value.
 - B. The 10% recourse debt limitation now includes all Subscription Financing amounts in addition to Credit Accommodations.
 - C. When calculating the amount of recourse debt for compliance with the 10% limitation, Staff will be required to use the total Recourse Debt Allocated amount as opposed to the amount currently outstanding. For example, if an investment partner has been allocated \$100 million of credit accommodation, of which only \$60 million has been utilized, the full \$100 million will be counted towards the 10% recourse debt limitation.
 - D. The total amount of current Subscription Financings Outstanding and Credit Accommodations Outstanding will now be counted towards the portfolio LTV limits.
4. **Previous Real Estate Policies.** Section XII was added listing the current real estate policies that will be superceded by the proposed policy.

Consultants' Concurrence

The Real Estate Consultant, PCA, and General Pension Consultant, Wilshire, have provided review and concurrence letters on proposed Staff changes (Attachments 2 and 3 respectively).

Transitioning to New Policy

Upon adoption of this policy, Staff and the Real Estate Consultant will review the portfolio for compliance with the policy. In order to comply with the policy, the AREIS Database Project will need to be implemented and fully operational. The expected AREIS implementation date is June 2009. Additionally, existing operating agreements will need to be reviewed to ensure compliance with the new policy. Staff and the Real Estate Consultant will recommend to the Investment Committee that the Committee engage an independent third-party consultant to complete the existing operating agreement review. The proposed policy also calls for creation of a new Staff Internal Procedures Manual. An independent third-party consultant has been engaged with oversight from the Real Estate Consultant to assist with development of the Staff Internal Procedure Manual.

Given current market conditions and the structure of the real estate portfolio, Staff estimates it will take three to five years to transition the portfolio to full compliance with the proposed policy. The new policy includes extensive reporting requirements that will apprise the Investment Committee on progress toward full compliance.

As shown in the timeline below, Staff will present to the Investment Committee in June 2009 a revised Real Estate Delegation Resolution that will address authority for: 1) new investments, and 2) interim management of the portfolio during the three to five year transition period to bring the portfolio in full compliance with the proposed policy. In June, Staff will propose interim measures related to interim management authority such as extending loans, paying down debt, and deploying new capital to existing projects. Staff will also propose interim measures with respect to delegated authority for the For Sale Residential and Land Development ("Housing") and CURE programs in the revised Delegation Resolution. Prior to the adoption of new delegated authority, the Housing program will continue to be operated under an interim authority which requires the following for any investment decision:

1. SIO-RE approval;
2. A concurring recommendation from the Board's Real Estate Consultant;
3. A concurring recommendation from the applicable third party housing consultant; and
4. Any investment with a new housing partner requires Investment Committee approval.

Staff will also be developing new strategic plans for the Housing and CURE programs in 2009. Upon approval of the new strategic plans by the Investment Committee, Staff will revise the respective policy attachments for the programs and submit proposed policy drafts to the Policy Subcommittee in 2010. During the interim period, the current policy attachments will apply.

Additionally, the existing real estate policy for the Agricultural Land Real Estate Program will remain in effect as a stand alone real estate policy until a determination is made regarding the transfer of agricultural land investments to the Inflation-Linked Asset Class. The real estate policy for the Responsible Contractor Program ("RCP") will also stand alone as a separate policy. Staff is currently working on a revised RCP draft to submit to the Policy Subcommittee in June 2009.

Implementation Timeline

The following timeline outlines the steps Staff is proposing to complete the Real Estate Portion of the Policy Review and Consolidation Project:

Implementation Action	Expected Timing
Staff submits policy draft to PSC to begin Board review process.	Completed (1 st Reading)
Staff submits policy draft to PSC for additional review and comment.	Completed (2 nd Reading)
Real Estate Staff and LEGO complete analysis of Hazardous Waste risks and recommend placement of mitigation measures in Staff Internal Procedure Manual.	Completed
Staff submits policy draft to PSC for additional review and comment.	April 2009 (3 rd Reading)
Staff submits proposed Real Estate policy to Investment Committee upon approval of PSC.	June 2009
Staff submits revised Real Estate Delegation to Investment Committee for review and approval.	June 2009
Staff submits RCP policy draft to PSC for review and comment.	June 2009
INVO Operations Staff submits proposed policies for Real Estate Accounting and Real Estate Appraisal of CalPERS Interests to the PSC for review and comment.	June 2009
Staff submits proposed RCP policy to Investment Committee upon approval of PSC.	August 2009
INVO Operations Staff submits proposed policies for Real Estate Accounting and Real Estate Appraisal of CalPERS Interests to the Investment Committee upon approval of PSC.	August 2009
Independent third-party consultant completes review of existing operating agreements for compliance with new policy and submits findings to the Investment Committee.	November 2009
Independent third-party consultant and Staff complete development of Staff Internal Procedure Manual.	December 2009

Staff completes new strategic plans for the Housing and CURE programs.	December 2009
Upon IC approval of new strategic plans for the Housing and CURE programs, Staff submits new policy attachments to PSC for review and comment.	First Half 2010

V. STRATEGIC PLAN:

The Real Estate Policy Review and Consolidation Project will further the following CalPERS Strategic Plan goals:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

There are no material costs associated with this agenda item.

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